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No. 187

In the Supreme Court of the United States

OCTOBER TERM, 1935

THE G AND K MANUFACTURING COMPANY,
PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE RESPONDENT

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OPINIONS BELOW

The memorandum opinion of the United States Board of Tax Appeals (R. 39–42) is unreported. The opinion of the Circuit Court of Appeals (R. 72–78) is reported in 76 F. (2d) 454.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 3, 1935. (R. 78.) The petition for a writ of certiorari was filed June 28, 1935, and

granted October 14, 1935. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the definition of the term "reorganization" contained in clause (A) of Section 112 (i) (1) of the Revenue Act of 1928 should be limited to transactions which partake of the nature of mergers or consolidations.

STATUTE INVOLVED

The pertinent sections of the statute involved will be found in the Appendix, *infra*, pp. 16–18.

STATEMENT

The facts as stipulated (R. 13–37) and as found by the Board of Tax Appeals (R. 39–41) may be summarized as follows:

On August 23, 1929, petitioner entered into an agreement for the transfer of certain assets to the Kraft-Phenix Cheese Corporation. (R. 17–25, 39.) This agreement recited that the petitioner desired to sell, and that Kraft-Phenix Cheese Corporation desired to purchase, the assets specified by a statement attached to the agreement. (R. 17, 18.) On November 12, 1929, the parties agreed upon a change in the "purchase price." (R. 14, 36–37, 40.)

On November 12, 1929, pursuant to these agreements, petitioner transferred the said assets to Kraft-Phenix, receiving in exchange $200,000 and

17,250 shares of the common stock of Kraft-Phenix. (R. 14, 40.) The business and assets of the Gelfand Manufacturing Company of California and the Pickle Products Company (subsidiaries of petitioner (R. 20)) were not included in the transfer to Kraft-Phenix. (R. 18.) Petitioner agreed not to engage in any similar competitive business for a period of ten years except in the States of California, Washington, Oregon, Idaho, Utah, Nevada, Arizona, and Montana. (R. 20–21.) Petitioner corporation remained in existence, and so far as the record shows it remained in business. (R. 42.)

On November 12, 1929, the price range of the common stock of Kraft-Phenix upon the New York Stock Exchange was from $28 to 32⅞ per share, or an average of $30.4375. (R. 16, 40.)

Petitioner reported a profit on the sale of its assets and treated the stock of the Kraft-Phenix Cheese Corporation as having a fair market value of $20 per share. (R. 4, 9.) The Commissioner of Internal Revenue determined an additional profit by valuing the stock at $30.4375 per share. (R. 4, 9, 41.) On April 1, 1932, petitioner filed a petition for review of the Commissioner's determination by the Board of Tax Appeals, its sole contention then being that the Commissioner erred in thus increasing the value of the stock. (R. 3.) This petition alleged that the transfer was a sale. (R. 4.) On June 7, 1933, petitioner filed an amended petition with the Board of Tax Appeals, alleging that the transaction was a sale and that the

Commissioner erred (1) in increasing the value of the stock from $20 to $30.4375 per share, and (2) in including as income any part of the value of the 17,250 shares of stock of the Kraft-Phenix Cheese Corporation. (R. 5–6.) A second amended petition was filed with the Board of Tax Appeals at the hearing on December 14, 1933 (R. 13), in which petitioner challenged the respondent's determination upon the ground that the transaction with the Kraft-Phenix Cheese Corporation was a reorganization within the meaning of the Revenue Act, and an additional ground which is excluded from consideration here by reason of the limitation of the writ of certiorari.

The Board of Tax Appeals held that the transaction was not a reorganization within the meaning of the Revenue Act of 1928, and that the shares of stock of Kraft-Phenix Cheese Corporation received by petitioner had a fair market value of $30.4375 per share as determined by the Commissioner. (R. 41–42.) The Circuit Court of Appeals affirmed the Board in all respects. (R. 74–78.)

SUMMARY OF ARGUMENT

1. The definition of "reorganization" upon which petitioner relies is contained in the same parenthetical clause discussed in the brief for the petitioner in *Guy T. Helvering, Commissioner of Internal Revenue* v. *Minnesota Tea Company*, No. 174, present term. For the reasons there stated, we contend that the definition should be limited to

mergers or consolidations or to transactions which partake of their nature.

2. The transaction here involved fails substantially to conform to a number of basic elements found in mergers and consolidations which are required by the Revenue Act. There was no plan of reorganization; petitioner has not shown that it transferred substantially all of its assets; the proportion of stock to other property received as consideration was so large that petitioner's proprietary interest was substantially changed; petitioner did not dissolve; petitioner's stockholders did not become stockholders of the other corporation and the other corporation did not assume all of petitioner's liabilities; petitioner reserved the right to compete with the other corporation and the two corporations were not associated in any common enterprise; petitioner sold a portion of its proprietary interest and substantially changed its position.

ARGUMENT

I

THE STATUTE CONTAINS TWO OVERLAPPING DEFINITIONS OF REORGANIZATION. THEY CAN BE RECONCILED ONLY BY RESTRICTING THE CLAUSE (A) DEFINITION TO TRANSACTIONS WHICH RESULT IN MERGERS OR CONSOLIDATIONS OR PARTAKE OF THEIR NATURE

The general rule of the statute is that the gain upon an exchange is taxable. To this there are certain well-defined exceptions. Petitioner contends

that the transaction here involved is literally within the scope of one of the exceptions, namely, Section 112 (b) (4), Revenue Act of 1928 (*infra,* p. 16), which provides as follows:

> No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, *solely for stock or securities in another corporation a party to the reorganization.* (Italics supplied.)

This provision is qualified by Section 112 (d) (*infra,* p. 16), which provides that money or property other than stock or securities may enter into the transaction, but, if not distributed by the corporation pursuant to the plan of reorganization, shall be taxable to the extent that gain is involved.

Petitioner transferred certain of its assets to another corporation in exchange for cash and stock and the case turns upon whether the transaction was a reorganization.

Section 112 (i) (*infra,* p. 17) defines the term "reorganization" as follows:

> (1) The term "reorganization" means (A) a merger or consolidation (*including the acquisition by one corporation of * * * substantially all the properties of another corporation*), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to

which the assets are transferred * * *. (Italics supplied.)

Petitioner relies particularly upon the italicized language appearing in the parenthesis. In view of the fact that a similar transaction is included in the portion of the definition in clause (B), the two provisions will overlap unless the clause (A) definition is limited. The Government contends that this parenthetical language is colored and controlled by the words "merger or consolidation" and that to be within the definition a transaction must partake of the nature of a merger or consolidation, though it fails to satisfy all of its legal requirements. This contention is fully developed in the brief for the petitioner in *Guy T. Helvering, Commissioner of Internal Revenue* v. *Minnesota Tea Company,* No. 174, present term, and Point I of the argument in that case is incorporated herein by reference.

II

THE TRANSFER TO THE KRAFT-PHENIX CHEESE CORPORATION DID NOT SUFFICIENTLY PARTAKE OF THE NATURE OF A MERGER OR CONSOLIDATION TO BE TREATED AS A REORGANIZATION

Petitioner transferred certain assets to the Kraft-Phenix Cheese Corporation pursuant to two written agreements. Petitioner received in exchange $200,000 cash and 17,250 shares of the common stock of Kraft-Phenix. Petitioner agreed to, and did, change its name. It remained in existence and reserved the right to engage in a competitive business.

We think that the transaction fails in several particulars to satisfy the statutory requirements: (1) There was no plan of reorganization; (2) petitioner has not shown that it transferred substantially all its assets; (3) the proportion of stock to other property received as consideration was so large that petitioner's proprietary interest was substantially changed; (4) both the Kraft-Phenix Cheese Corporation and petitioner remained in existence after the transaction; (5) Kraft-Phenix did not assume all of petitioner's liabilities; (6) petitioner's stockholders did not become stockholders of Kraft-Phenix, nor was it a part of the plan that they should.

We shall briefly discuss each of the points enumerated above.

(1) The record shows that the transaction occurred as the result of an agreement dated August 23, 1929 (R. 17), as amended by a supplemental agreement (R. 35) and a further agreement of November 12, 1929 (R. 36). Upon these dates petitioner was doing business under the name of Gelfand Manufacturing Company. (R. 14.) The agreement of August 23, 1929, recites that (R. 17):

> Gelfand *desires to sell* its entire business and assets and Kraft-Phenix is ready and willing *to purchase* said business and assets * * *. (Italics supplied.)

In paragraph First (R. 17) Gelfand agreed to sell, and in paragraph Second (R. 18) Kraft-Phenix

agreed to purchase. The agreement is couched in terms of sale throughout, and nowhere is there mentioned a plan of reorganization, nor is any purpose disclosed to continue the business under a modified corporate form. The supplemental agreement of November 12, 1929 (R. 36–37) referred to the agreement of August 23, 1929, as one "for the sale" of certain assets and made a modification in the "purchase price."

Here, as in *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462, the negotiations were in terms of purchase and sale and no purpose to reorganize appears. Moreover, petitioner never contended that the transaction was a reorganization until December 14, 1933, when the second amended petition was filed with the Board of Tax Appeals. (R. 11–13.) In the original petition filed with the Board of Tax Appeals April 1, 1932 (R. 3–4), it was contended that petitioner had sold its assets. In the first amended petition filed June 7, 1933 (R. 5–7), it was again contended that petitioner had sold its assets. It thus appears that for 3½ years after the transaction occurred, petitioner maintained that it should be treated as a sale. We submit that a plan of reorganization which this Court, in *Gregory* v. *Helvering,* 293 U. S. 465, held to be essential is not shown by this record.

(2) Petitioner did not transfer all of its assets to Kraft-Phenix Cheese Corporation. The Board of Tax Appeals found (R. 40) that petitioner trans-

ferred "its business and assets as specified in the two agreements". This was in the language of the stipulation. (R. 14.) The agreement of August 23, 1929, recited (R. 17) that petitioner agreed to sell "the assets shown on the statement of June 30, 1929," which was attached as Exhibit "A" (R. 25) and purported to list the assets of the "Main Baltimore Plant". The agreement further provided (R. 18) that certain assets were "to be expressly excluded from said sale and purchase". Those assets comprised the shares of capital stock of two subsidiaries, real estate, building and loan association accounts, and amounts due from petitioner's officers. By the supplemental agreement (R. 35–36) certain insurance was also excluded from the transaction. The value of none of this excluded property is shown, nor is there any indication of its proportion to the whole value of petitioner's property. Under these circumstances, petitioner has failed to clearly show that the transfer consisted of "substantially all" its property, and hence has not brought itself within the statute upon any construction.

(3) The 17,250 shares of stock which petitioner received for its assets were valued at $30.4375 per share (R. 41), or a total of $525,046.88. In addition petitioner received $200,000 in cash. In the statement attached to the agreement (R. 25–26) petitioner claimed total assets of $1,391,779.22, against which there were liabilities of $276,286.46,

making the net value of the assets $1,115,492.76. The original agreement called for the payment by Kraft-Phenix of $1,115,492.76, of which $600,000 was to be in cash and the balance in stock. (R. 18.) This would have resulted in petitioner parting with its assets for approximately 55% cash and 45% stock, and would have been a radical change of position. The cash was later reduced to $200,000 (R. 37), for which there is no explanation. However, the $200,000 cash represented 27½% of the total consideration, and accordingly petitioner *pro tanto* disposed of its proprietary interest in its assets. As stated in the brief for petitioner in *Guy T. Helvering, Commissioner of Internal Revenue* v. *Minnesota Tea Company,* No. 174, present term, cash and property other than stock or securities were permitted to enter into a reorganization only as "boot", and we therefore submit that the proportion of cash to stock in this case is too great to be treated as a mere formal change.

(4) After the transaction petitioner and Kraft-Phenix existed at the same time, pursuing their separate activities. Petitioner remained in existence (R. 42), changed its name (R. 14, 22), and reserved the right to engage in a competitive business in eight western States (R. 22). It retained the stock of two subsidiaries (R. 18) and reserved the right for one of them to engage in a competitive business in the same eight States (R. 21). Kraft-Phenix agreed to refrain from using certain trade

names in those eight States, the right to such use being reserved to petitioner's subsidiary. (R. 35.) Since the statute does not deal with a mere association of co-existing corporations, but with a continuing business in a new form, we submit that the fact that petitioner remained in existence, and presumably remained in business independently of Kraft-Phenix, serves to emphasize the point that petitioner's corporate business was not merely continued in a new form. Petitioner and Kraft-Phenix were not jointly engaged in business. They were separate corporations and potential competitors. For the reasons more fully discussed in the *Minnesota Tea* brief, we submit that the transaction here involved fails to meet an important requirement.

Petitioner contends (Br. 14) that a requirement that it dissolve would be inconsistent with the requirement that a continuity of interest be preserved. The statute contemplates that the continuity of interest may be preserved through the stockholders (Section 112 (b) (3)), and petitioner could dissolve and satisfy the statute in this respect by distributing the Kraft-Phenix stock to its own stockholders. The provision relieving corporations from tax upon receipt of stock in a reorganization was added in the Revenue Act of 1924 (c. 234, 43 Stat. 253) in recognition of the fact that the exemption of stockholders only would expose the corpora-

tions to tax even though they distributed the new stock and that this would be an impediment to the ordinary business transactions which Congress desired to encourage. See House Report No. 179, 68th Cong., 1st Sess., p. 13; Senate Report No. 398, 68th Cong., 1st Sess., pp. 14–15.

The Circuit Court of Appeals did not put its decision solely upon the ground that petitioner failed to dissolve, but emphasized the fact that it "remained in existence, possessed of a substantial amount of money, qualified to engage in active business in its own capacity or through its subsidiaries, and with the intent so to do, so far as the record shows." (R. 76–77.) Even though technical dissolution may not be a requisite, we think that a corporation which transfers its assets to another corporation and remains in active business competition with it cannot be said to have joined the other corporation in a transaction which partakes of the nature of a merger or consolidation.

(5) Only those liabilities of petitioner disclosed by the statement attached to the agreement (R. 17–18, 26) were assumed by Kraft-Phenix, and the latter required an indemnity contract to protect it against undisclosed liabilities. (R. 21.) As pointed out in the *Minnesota Tea* brief, it is one of the indicia of a merger or consolidation, as distinguished from a sale, that the successor corporation undertakes to assume the liabilities of the old companies.

(6) Petitioner's stockholders did not become stockholders of Kraft-Phenix. It was a part of the plan that the petitioner corporation should continue to own and hold the stock acquired for its assets. As pointed out in the *Minnesota Tea* brief, this has the effect of making the dividends nontaxable, with the result that after this transaction petitioner reported neither the profits earned by its former assets nor the dividends declared by the new management. It is difficult to believe that Congress intended to encourage such a result.

Petitioner contends (Br. 24) that the common stock of Kraft-Phenix which it acquired in this transaction was distributed pursuant to a plan of reorganization because it was deposited pursuant to a later plan of sale or exchange between Kraft-Phenix and the National Dairy Products Company. We think it is clear that Section 112 (d) (1) of the Revenue Act of 1928 deals with a distribution to stockholders and relieves the corporation from the tax only because the stockholders will assume it. However, the proper construction of the section would seem to be unimportant here, for it does not deal with stock acquired in a reorganization, but with "other property or money", and petitioner does not contend that it distributed the cash which it received.

CONCLUSION

In view of the foregoing, we submit that the decision of the Circuit Court of Appeals should be affirmed.

Respectfully submitted.

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NOVEMBER 1935.

APPENDIX

STATUTE INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791, 815, 816:

SEC. 111. DETERMINATION OF AMOUNT OF GAIN OR LOSS.

* * * * *

(c) *Amount realized.*—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General rule.*—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) *Exchanges solely in kind.*—

* * * * *

(4) *Same—Gain of corporation.*—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

* * * * *

(d) *Same—Gain of corporation.*—If an exchange would be within the provisions of subsection (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securi-

ties permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then—

(1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange; but

(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed.

* * * * *

(i) *Definition of reorganization.*—As used in this section and sections 113 and 115—

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

(2) The term "a party to a reorganization" includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the vot-

ing stock and at least a majority of the total number of shares of all other classes of stock of another corporation.

(j) *Definition of control.*—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

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